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To:
Dr Michael Cullen

From
Rob Cameron

By
Facsimile

Date
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Air New Zealand Update

This fax provides an update on the major aspects of the Air New Zealand situation.

Air New Zealand

In our briefing earlier this week we informed you that:

- The Air New Zealand position on whether or not Virgin Blue is critical to the recovery strategy was unclear; and
- The amount of capital required for the recovery plan might be reviewed upward.

We wrote to Air New Zealand earlier this week indicating that the Government would require a clear view on these issues from the Directors prior to making any decisions. We invited Air New Zealand to review their position and have it confirmed by the Board before the end of this week.

At the time of writing this note, the Board has not yet formally addressed these issues. The management position appears to be that:

- An early acquisition of Virgin Blue is necessary for the turnaround strategy because in the absence of that acquisition the capital requirements are too large to be met by existing shareholders (assuming SIA capped at 49%) and may be commercially unjustifiable.

- The capital required with an early Virgin Blue acquisition may be as high as $1.5 billion. A business plan without Virgin Blue probably requires funding in excess of $1.5 billion and management's preliminary view is that $1.5 billion could not be raised with Virgin Blue still competing in the market.

If these preliminary management views are confirmed and supported by the Board there are a number of implications for Air New Zealand, the Crown, SIA and the timetable for the current process.

Implications

(a) Air New Zealand

We have not yet done sufficient work to reach any conclusions but we have some concern as to whether a capital raising of $1.5 billion is possible and justified commercially even with the acquisition of Virgin Blue. We have raised a number of issues with Air New Zealand and their advisors and have asked them to revert with a more detailed analysis as soon as possible.

At the very least, it appears that a capital raising of this size implies a heavy reliance on the certification provided by a placement to SIA and the Crown at around the current share prices. It is not clear that there is a commercial justification for the Crown subscribing for new shares at around the current share price if the required capital raising is $1.5 billion.

(b) The Crown

The "working" assumption contained in the Air New Zealand analysis is that the Crown would acquire a 7% interest for $240 million alongside an SIA contribution of $975 million which would take them to 49%.

If the Crown chooses not to contribute, it is likely that other new investors will need to be found if SIA is capped at 49%.

(c) SIA

It is unlikely that SIA has been envisaging capital contribution at this level. We anticipate that it will almost certainly have to revert to the SIA Board and there can be no guarantee that it will support the new proposals (assuming they are submitted to, and approved, by the Air New Zealand Board.

(d) Timetable

We think it unlikely that Air New Zealand will resolve its position in sufficient time for a Government decision to be made on Monday 27 August.

Also, if Virgin Blue does become an essential element of the business case approved by the Board, timetabling issues are created by the need for ACCC approval.

Currently, negotiations are underway with the owners of Virgin Blue and it appears that resolution on the key commercial terms for the sale may be reached relatively quickly. This would allow Air New Zealand to proceed to the ACCC using the 'reverse failing business' argument.

At best, ACCC approval might take two weeks but there is risk it could take longer.

If the acquisition is considered critical to the business case, and Air New Zealand sought to meet the current announcement timetable it would be put in the position of saying a capital raising had been agreed subject to ACCC approval of the Virgin Blue acquisition. This would leave open the question of what happened if the ACCC declined approval.

Air New Zealand's current view is that this is unsatisfactory and they are consequently considering seeking a time extension of a week or two from the NZSE with respect to their announcement. Their intention would be to use the time extension to get the Virgin Blue proposal finalised one way or the other prior to making an announcement.

It is likely that the timetable issues will be resolved over the next day or two.

Proposed Response to the Above Situation

The Crown Negotiating Team proposes to continue pushing Air New Zealand to resolve its position as soon as practicable. In particular, the Board needs to finalise its view on:

- The capital raising amount and feasibility.
- The role of Virgin Blue in the business plan going forward.
- The timetable.

As these issues develop over the next day or two we will need to work with Air New Zealand and SIA to develop an integrated strategy for handling the reasons for any timetable changes and addressing Air New Zealand's revised requirements.

From the Government's point of view, it may wish to consider its position on the maximum ownership level for SIA given that the current Air New Zealand analysis assumes the Government contributing $240 million with SIA at 49%.

SIA Proposal

SIA were due to come to Wellington earlier today to finalise negotiations on their proposal. This visit has been deferred pending the finalisation of the Air New Zealand issues outlined above.

The National Interest Package elements of the Singapore proposal have been progressed but have not yet been finalised. Finalising them is not expected to be controversial.

There is still some potential for controversy over governance issues with the allocation of board seats and rights over the Chairman and Chief Executive Officer appointments still not finalised. However, it is not useful to try and finalise these issues while shareholdings are still undecided.

Qantas Proposal

Discussions have been completed with Qantas. A National Interest Package has been finalised for the Government's consideration.

The Qantas proposal still suffers from commercial difficulties with respect to the acquisition of the SIA shareholding. Qantas have a new proposal with respect to this acquisition. They have proposed that the Government could deem Qantas a New Zealand person and allow them to purchase the BIL A shares. This would effectively put Qantas in control and Qantas are confident they could remove SIA commercially at that point.

The proposal also faces competition regulation difficulties in both New Zealand and Australia that, at best, will require time and commercial transactions to resolve.

One issue that has not been addressed with Qantas is Air New Zealand's capital needs. Given the latest numbers emerging from Air New Zealand it is almost certain that Air New Zealand will need capital under the Qantas deal because the loss on the sale of Ansett will be significant. The contribution of capital by Qantas has not been discussed with them. Our judgement is that it is unlikely to be a "deal breaker" with Qantas although the Crown/Air New Zealand negotiating position is not likely to be strong if matters progress that far.

We will provide further updates over the next day or two as the issues above are clarified.

If you wish to discuss any of the above please ring Rob Cameron on or Murdo Beattie on .